

July 16, 2004

Mr. Peter O'Dell
Acting Board Secretary
Ontario Energy Board
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RE: PROCESS FOR ESTABLISHING 2006 ELECTRICITY DISTRIBUTION RATES

This letter is response to the OEB's request for input as to the issues that need to be considered in establishing 2006 distribution rates for Ontario's electricity distributors. The comments are offered by Econalysis Consulting Services (ECS) staff and represent the views of the undersigned – as opposed to the views of any clients ECS has or may represent in the future.

Objective

During the recent July 6-7, 2004 informal consultation process, OEB staff identified 3 goals for the process:

1. Establish a common “cost of service” methodology to use when setting new revenue requirements for 2006 electricity distribution rates.
2. Review a limited number of rate design issues as part of setting 2006 rates.
3. Clarify the potential impact on 2006 rates process of smart metering or long-run DSM initiatives.

ECS considers the first of the three goals to be the most important and that the reference to “cost of service” is critical. As the Board is aware the first generation PBR scheme (PBR-I), was initiated with the Board approval of electricity distribution rates based on 1999 distribution costs – without any formal review as to whether the 1999 costs represented an appropriate cost of service (exclusive of return) for the individual distribution utilities concerned. The use of 1999 costs as the basis for rate setting at that time was acceptable given the demands on the OEB with the industry restructuring that was taking place, the need to put unbundled rates into place expeditiously and the fact that the OEB had just assumed responsibility for the regulation of Ontario's electricity distributors.

However, the use of 1999 costs to set rates going forward did not provide the type of regulatory assurance to customers that their rates were fair and reasonable that a traditional cost of service review would have. Similarly, it did not provide utilities with the opportunity to “apply for” the cost of service they believed was required in order to meet the reliability and quality of service standards dictated by the Board. This shortcoming was generally recognized at the time and commitments made¹ that more comprehensive cost of service reviews would be undertaken prior to the advent of any second generation PBR scheme. The industry is now nearing the conclusion of the first generation PBR and it is imperative that this commitment be met so that rates will be just and reasonable going forward into 2006 and potentially into a future PBR-II scheme in 2007.

Given this perspective, the objective of the Board should be to develop a “common cost of service methodology” that includes:

- a standard set of issues that need to be dealt with by all utilities in order to both assure customers that rates are revenue requirements is just and reasonable and to provide utility shareholders with the opportunity for reasonable returns.
- a further set of issues that utilities would be required to address if they represent more than a prescribed portion of the revenue requirement. Examples could include environmental remediation costs, IT costs, advertising costs and R&D costs.
- a basis for determining a just and reasonable level of costs through the use of comparators.

At the same time the process for establishing 2006 distribution revenue requirements should provide the opportunity for a full formal public cost of service review for utilities that seek exceptions to the “common methodology”. This step is critical as it will enable the Board to develop fairly prescriptive and aggressive comparators since the “common methodology” does not have designed to accommodate all circumstances – just the vast majority. Even here, it must be recognized that effective regulation can not be sacrificed solely in the interest of administrative effectiveness.

ECS is concerned that calls for light-handed regulation are premature until the Board has satisfied itself with some degree of rigour that the overall revenue requirement level approved for distribution utilities are reasonable. Light-handed regulation is an achievable goal for PBR II if the 2006 base cost of service produces just and reasonable rates

¹ OEB Decision RP-1999-0034, Paragraph 2.1.2 and Ontario Energy Board Electricity Distribution Rate Handbook, Paragraph 2.3.3

Issues to be Considered

ECS suggests that as part of the lead-in to the formal consultation and Board Proceeding on the Issues List, Board Staff articulate a Cost of Service presentation that may meet their expectations. This is not to prejudge the outcome but rather to provide guidance to the discussion of the issues. This could be done in discussion format and would assist the process. We provide suggestions on this under next steps.

ECS understands that the purpose of this initial consultation is to solicit input regarding the issues that should be considered in developing a common cost of service methodology. The intention is not to debate merits of a particular approach to an issue. The opportunity for such debate will come later. Between the Board staff's Potential Issue List (attached to the Board's June 16th, 2004 letter) and the points raised by participants during the July 2004 informal consultation, a fairly comprehensive list of issues have been identified for consideration as part of the process for establishing 2006 electricity distribution rates. However, ECS has couple of additional issues it would like to bring to the Board's attention:

Comparators

As well as comparing costs across utilities based on appropriate comparators (e.g., cost per customer), ECS believes the reasonableness of the test year's costs should also be gauged by looking at 2-3 years of historical costs. For example, if 2004 is to be the "test year" for determining the appropriate level of costs, one of the appropriate benchmarks by which to test reasonableness would be to disaggregate the 2004 costs (by USOA) and compare the 2004 values with those for 2001, 2002 and 2003.

Retailer Costs and Revenues

Issues to be considered here would be the basis for costing services provided to retailers, the resulting rates and the associated revenues.

Service Quality and System Reliability

Utilities should be required to report on their service quality and system reliability performance. Furthermore, utilities who are struggling to meet the OEB's prescribed service quality and reliability measures based on historical spending levels should be required to identify the underlying causes of any such deficiencies; put forward an action plan to address the gap between actual and required performance and identify the implications, if any, for the utility's future revenue requirements.

Next Steps

1) Relating to Issues 1-28 on the draft issues list of June 16, 2004

ECS suggests that Board Staff provide a draft COS presentation that may be appropriate for review of 2006 revenue. This would greatly assist in a tailored discussion of the COS presentation, filing requirements and the draft issues list.

Rather than develop COS presentation from scratch we believe the presentation accepted by the Board that lead to its Decision in RP-1998-0001 regarding the Hydro One Networks' Transitional Rate Order for Distribution Rates should be reviewed as a starting point. For example in the area of Financial Schedules, the regulatory schedules set out in the Board's Decision² could be reviewed with a view to deciding whether to use these as a Template in modified or amended form. Once this has been done, the USOA regulatory accounts associated with each line item would be identified and then a line by line review of the type of information and the level of detail to be filed in support the revenue/expense amount could be undertaken.

For non-financial information such as Service Quality performance the information in the utility filing reports would be a basis for the presentation.

The Board staff could also assess the potential scope and complexity of a COS regulatory financial model that would be available to utilities to facilitate their COS presentations and filings.

Finally, if feasible, it would be desirable to have a sufficient amount of financial and PBR data that is filed annually with the OEB made readily accessible on public basis. It is ECS' view that this would facilitate the discussion on cost comparators.

2) Review limited number of rate design issues as part of setting 2006 rates

ECS recognizes that with the plan to delay cost allocation and rate design issues to some time in 2006, there will be a need to address some rate design issues as part of the process for establishing 2006 electricity distribution rates.

ECS notes that although issues 29-33 are valid – they include both issues that may have broad applicability such as customer-specific charges and some that are narrower such as Time of Use rates. In most cases, the requirement to file information and address the issue could be subject to specific materiality criteria. Furthermore, for many of the issues such as

² Appendix A of the Decision

TOU, treatment of scattered loads and fixed/variable charges the approach for 2006 should specifically recognize that this is part of cost allocation/rate design and a broad range of acceptable results should be allowed, with only serious outliers undergoing a closer scrutiny.

3) Clarify potential impact on 2006 rates process of smart metering or long-run DSM initiatives

We are unable to comment on these issues since the details of these initiatives are still to come from the Board. In general, we have concerns that the agenda for both the utilities and the Board may become unmanageable if all three initiatives are to be in place for 2006.

We appreciate opportunity to comment on these important issues. Should Board Staff have any questions or require clarification please feel free to contact either of the undersigned.

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